

Impact of the SEC's 2024 Examination Priorities Report for Investment Advisers

Corporate News: A Legal Update

By Daniel Spungen on March 21, 2024

The Division of Enforcement ("Division") for the Securities and Exchange Commission ("SEC") released the 2024 Examination Priorities Report ("Report") highlighting the key areas the Division will examine in 2024.

The SEC's mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. The Division furthers the SEC's mission with its own "four pillar" mission – to promote compliance, prevent fraud, monitor risk, and inform policy.

The Division publishes its examination priorities as a mechanism to better inform investors and registrants of the key risks, trends, and examination topics the Division will analyze for 2024. Although the Report looks at a number of participants, this article focuses on the impacts for an investment adviser ("IA").

An IA is a fiduciary for its clients, meaning it must act in the best interests of its clients and not place its own interests ahead of those of its clients. With its fiduciary duty comes an IA's duty of care and duty of loyalty to its clients. The Division will ensure that an IA is fulfilling its fiduciary obligations through its examinations. For IAs, the Division will focus on the following:

- Investment advice provided to clients
- Conflicts of interest
- Compliance programs
- Advisers to private funds
- Market risks impacting various market participants

Investment Advice Provided to Clients

One of the key roles of an IA compared to a broker is the provision of investment advice to clients based upon their goals, holdings, and timeframe.

The Division plans on examining advice provided to clients with a particular focus on (1) complex products, such as derivatives and leveraged ETFs; (2) high cost and illiquid products, such as variable annuities, private offerings, and non-

traded real estate investment trusts (REITs); and (3) unconventional strategies that purport to leverage the current economic environment. In addition, the Division will likely look at specific advice to different types of clients. For instance, the Division may look at advice to older investors that may be looking for steady and stable returns compared to advice given to younger clients that are less risk averse.

Along with the advice given to clients, the Division will look at the processes used to provide such advice. Examinations will analyze the suitability of a client's holdings and portfolio, not only at the outset of the client relationship, but any ongoing advice given in consideration of the client's holdings at that time.

Other factors analyzed by the Division in providing investment advice are the costs that are involved in a recommended product or strategy, whether any conflicts of interest exist, and whether the IA sought best execution from its selected broker-dealer, factoring in the costs as well as the total range and quality of the services from the selected broker-dealer, in implementing the transaction.

Conflicts of Interest

Whether it is the manner in which IAs are compensated, or common ownership or control with a broker-dealer, conflicts of interest are inherent between the IA and its client. The existence of a conflict of interest itself does not necessarily mean that the IA and client cannot conduct the transaction. The Division will look at what steps the IA has taken to disclose, mitigate, and eliminate conflicts of interest in transactions with clients.

Economic incentives can lead to conflicts of interests for IAs. Some common incentives that may exist are revenue sharing, markups, or other revenue arrangements.

An economic incentive may exist with regards to allocation of investments between accounts, as the IA could receive higher fees depending on the fee arrangements of specific accounts.

IAs may be dually registered as or affiliated with a broker-dealer, have affiliated subsidiaries that perform client services, or have financial professionals servicing clients in a brokerage and/or advisory capacity.

IAs may also have access to proprietary investment products which may be beneficial to clients, but also inherently pose a conflict of interest.

All of these arrangements can lead to conflicts of interest, and the Division anticipates reviewing these arrangements to see whether IAs are taking the appropriate steps to eliminate, mitigate, or disclose such conflicts.

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If a conflict of interest exists, it is vital to provide full and fair disclosure of material information to the client about the existence of the conflict of interest. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.

The Division plans on prioritizing the disclosures given to clients and ensuring that they had the necessary information to give informed consent. Informed consent will allow the IA to conduct the transaction, provided that the IA has given full and fair disclosure. If, for example, the conflict is of a nature and extent that IA cannot give a full and fair disclosure nor can the IA mitigate the conflict, it should be eliminated.

Compliance Programs

IAs are required under 17 CFR § 275.06(4)-7 (the “Compliance Rule”) to “adopt and implement written policies and procedures reasonably designed to prevent violation” of the Investment Advisers Act of 1940 and rules promulgated by the SEC. The Division plans on focusing on compliance programs to ensure that they address the various aspects of an IA’s business.

Compliance programs should be tailored to the IA and address its types of clients, compensation structure, services offered, operations, affiliations, and any market risks applicable to the IA. Specifically, the Division’s examinations of an IA’s compliance program may look at any or all of the following:

1. Portfolio management processes;
2. Investor and regulator disclosures;
3. Proprietary trading by the advisers and personal trading activities of supervised advisory personnel;
4. Safeguarding of client assets;
5. Accurate creation, retention, and protection of required books and records;
6. Safeguards for the privacy of client records and information;
7. Trading practices;
8. Marketing advisory services;
9. Valuation processes; and
10. Business continuity plans.

The Division is also examining compliance programs to determine whether they properly address more recent concerns, guidance, or issues that have arisen since the adoption of the Compliance Rule. Specifically, the Division anticipates examining how a firm’s compliance program addresses:

1. The Marketing Rule;

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2. Compensation arrangements that focus on material payments, alternative ways that an IA may maximize revenue, and fee breakpoint calculation processes;
3. Valuation assessments of illiquid or difficult to value assets, such as real estate or private placements;
4. Safeguarding material non-public information;
5. Disclosures to regulators, with a focus on inadequate or misleading disclosures and registration eligibility;
6. Selecting a third-party or affiliated service provider;
7. Oversight of branch offices; and
8. Obtaining informed consent for material changes to advisory agreements.

Examinations of IAs to Private Funds

The SEC has prioritized examination of IAs that advise private funds. Private funds oftentimes hold illiquid investments and invest in companies at different stages of the companies' life cycle, from seed stage to series rounds.

Over the past few years, these funds have typically experienced a high degree of volatility, from first operating in the Zero Interest-Rate Policy period to the high interest rate environment that we are currently in. The Division will examine these IAs with an emphasis on:

1. Portfolio management risks when there is exposure to recent market volatility and higher interest rates;
2. Adherence to contractual requirements between the IA and private fund;
3. Accurate fee calculation and allocation of fees and expenses, including valuations, management fees, disclosures, and potential offsetting of fees;
4. Due diligence practices of the IA for consistency with the policies, procedures, and disclosures of the private fund;
5. Conflicts, controls, and disclosures regarding private funds managed side-by-side with registered investment companies and use of affiliated service providers;
6. Compliance with custody requirements; and
7. Policies and procedures for reporting on the newly adopted Form PF, including upon the occurrence of certain reporting events.

Market Risks Impacting Various Market Participants

The Report has a section dedicated to risks that are present across multiple participants, including IAs. The Division intends on examining the following areas in relation to IAs:

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1. INFORMATION SECURITY AND OPERATIONAL RESILIENCY

The Division wants to ensure that information is protected from cybersecurity attacks and also to ensure the inadvertent disclosure of customer information. Given the highly sensitive nature of the information held by an IA, this is a critical function and highly important to the Division.

Along those lines, the Division wants to ensure that an IA has plans in place to deal with service interruptions, whether through acts of nature or cyber incidents. Cybersecurity and incident response should be addressed in a firm's policies and procedures. The Division will likely want to see that the procedures are in place and that staff is adequately trained.

2. CRYPTO ASSETS AND EMERGING FINANCIAL TECHNOLOGY

As crypto assets and financial technology have become more widely available, the Division has prioritized the review of these new products and services during its examinations. The Division will examine to ensure that any products or services recommended comply with IA's standards of conduct, that the firms compliance programs are updated to handle these new products or services, ensure compliance with the Bank Secrecy Act, and custody requirements.

The Report highlights the key areas of focus for the SEC in 2024. IAs should seek legal counsel and consistently review the policies and procedures to ensure they are addressing the main areas of focus from the SEC and complying with the Investment Advisers Act of 1940.

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